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No. 83-1485

In the Supreme Court of the United States

OCTOBER TERM, 1983

JOSEPH A. MOLLER ET UX., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether petitioners' personal investment activities, which consist not of securities trading but of purchasing securities for long-term growth and dividend and interest income, constitute a "trade or business" within the meaning of Section 280A of the Internal Revenue Code, so as to enable them to deduct the cost of maintaining a home office for the conduct of those tasks.

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OPINIONS BELOW

The opinion of the Claims Court (Pet. App. A12-A27) is reported at 553 F. Supp. 1071. The opinion of the court of appeals (Pet. App. A1-A11) is reported at 721 F.2d 810.

JURISDICTION

The judgment of the court of appeals was entered on November 18, 1983. A timely petition for rehearing was denied on December 13, 1983 (Pet. App. A28). The petition for a writ of certiorari was filed on March 8, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Since 1965 petitioners have relied for their support almost entirely on income derived from investments in stocks and bonds (Pet. App. A1). During 1976 and 1977, the

tax years at issue, their portfolios were worth $13,500,000 and $14,500,000 respectively (*id.* at A2). Petitioners devoted their full time (about 40-42 hours per week) to managing their investments (*ibid.*). They made all their investment decisions on their own, assisted by several financial services and publications (*id.* at A2, A17).

Petitioners did not purchase securities for speculative purposes (Pet. App. A3). Rather, they were interested primarily in long-term growth potential and the payment of dividends and interest (*ibid.*). During 1976 and 1977, petitioners derived 98% of their gross income from dividends and interest (*ibid.*). They engaged in 19 sales of securities in 1976, resulting in a net gain of $612 (*id.* at A2 & n.1). They engaged in 23 sales of securities in 1977, resulting in a net loss of $223 (*ibid.*). The stocks that petitioners sold in 1976 and 1977 had been held for an average of 3 1/3 and 8 years respectively (*id.* at A2).

Petitioners maintained a winter home in Scottsdale, Arizona, and a summer home in Santa Barbara, California. Each house had an office that petitioners used exclusively for conducting their investment activities; their permanent files were kept in Scottsdale (Pet. App. A13, A20). The expenses attributable to maintaining these two home offices — depreciation, utilities, insurance, and maintenance — amounted to $7,440 in 1976 and $7,247 in 1977 (*id.* at A3 & n.2). Petitioners deducted these amounts on their joint income tax returns for 1976 and 1977.[1]

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[1]Besides deducting their home-office expenses, petitioners deducted numerous other items — subscriptions to financial publications, legal and accounting help, etc. — as investment expenses in each year. These other deductions totalled $15,220 in 1976 and $22,134 in 1977 (Pet. App. A3 n.3). The Commissioner agreed that these other items were properly deductible as "expenses for the production of income" under Section 212 of the Code, and the propriety of their deduction is not involved here.

On audit, the Commissioner disallowed petitioners' deduction of their home-office expenses, relying on Section 280A(a) of the Code.[2] That Section provides generally that "no deduction otherwise allowable under [the Code] shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence." Petitioners paid the resulting tax deficiencies and filed administrative claims for refund, citing Section 280A(c)(1)(A). That Section sets forth an exception to the general rule of Section 280A(a), providing that Section 280A(a) "shall not apply" to any expenses allocable to a portion of a dwelling unit used exclusively as "the principal place of business for any trade or business of the taxpayer." The Service denied the refund claims, contending that petitioners' portfolio-managment activities did not constitute a "trade or business." Pet. App. A3, A13.

Petitioners then filed this refund suit in the Claims Court. That court found as a fact that petitioners "would not qualify as traders in the securities market," concluding that they were "investors" who were "primarily interested in long-term growth and the payment of dividends by the companies in which they invested" (Pet. App. A20-A21). The court acknowledged (*id.* at A24-A25) that this Court, in *Higgins* v. *Commissioner*, 312 U.S. 212 (1941), had held that an investor's management of his securities portfolio generally does not constitute a "trade or business" for tax purposes. But the court found "the facts of the *Higgins* case [to be] readily distinguishable from the facts of the present case," reasoning that the taxpayer in *Higgins* was a "passive investor," whereas petitioners were active investors who engaged in "regular, extensive, and continuous activities" in

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[2]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

managing their stocks (Pet. App. A21, A25). The court accordingly held petitioners entitled to deduct the expenses of maintaining both home offices (*id.* at A27).

The court of appeals unanimously reversed (Pet. App. A1-A11). It held that a taxpayer's personal portfolio-management activities rise to the level of a "trade or business" only if he is a "trader" rather than an "investor," that is, if his activities are "directed to short-term trading, not the long-term holding of investments," and if his income is "principally derived from the sale of securities rather than from dividends and interest" (*id.* at A5-A6). The fact that petitioners were active investors who "spent much time managing a large amount of money" was not, in the court's view, "determinative of the question whether they were engaged in a trade or business" (*id.* at A8). This result, the court concluded, was supported by this Court's decision in *Higgins*, which held (312 U.S. at 218) that management of one's investments is not a trade or business "[n]o matter how large the estate or how continuous or extended the work required may be." Since the Claims Court had found as a fact that petitioners were investors rather than traders (Pet. App. A6-A7), the court of appeals concluded that they were not engaged in a "trade or business" and hence were not entitled to deduct their home-office expenses.[3]

ARGUMENT

The decision below is correct. Contrary to petitioners' contention, there is no conflict among the circuits on the question presented. There is no basis for review by this Court.

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[3]Having held that petitioners were not engaged in a "trade or business," the court of appeals did not reach the government's alternative contention (Pet. App. A11) that, even if petitioners were in a trade or business, that trade or business could be conducted at only one "principal place," so that the Claims Court had erred in allowing deductions for both home offices.

1. Section 280A provides generally that otherwise-deductible expenses incurred in connection with business or income-producing activity may not be deducted if attributable "to the use of a dwelling unit which is used by the taxpayer * * * as a residence." I.R.C. §§ 280A(a), 280A(b). Section 280A(c)(1)(A) provides an exception to this rule. It permits the deduction of home-office expenses allocable to that portion of the dwelling unit exclusively used on a regular basis as "the principal place of business for any trade or business of the taxpayer."

The legislative history of Section 280A shows that "trade or business" has the same meaning there as in Section 162(a), which provides a deduction for ordinary and necessary expenses paid or incurred "in carrying on any trade or business." The Committee Reports explain that a taxpayer, before Section 280A's enactment, might have deducted home-office expenses either under Section 162(a), if incurred "in carrying on any trade or business," or under Section 212(1), if incurred "for the production or collection of income." S. Rep. 94-938, 94th Cong., 2d Sess. 144 (1976); H.R. Rep. 94-658, 94th Cong., 1st Sess. 157 (1975). One purpose underlying Section 280A was to eliminate the home-office deduction for expenses of the latter sort, that is, expenses incurred solely in connection with income-producing activities. As the court of appeals properly concluded, "The legislative history of Section 280A makes clear that a taxpayer can no longer take a home-office deduction for an activity where it is for the production of income within the meaning of section 212 but is not a 'trade or business' under section 162." Pet. App. A5, citing S. Rep. 94-938, *supra*, at 149. See. H.R. Rep. 94-658, *supra*, at 161.

As petitioners note (Pet. 6-7), the Reports accompanying Section 280A imply that investment activities may constitute a "trade or business" under certain circumstances. The

Reports, however, do not specify what those circumstances are. Since "trade or business" is not defined in Section 280A (or elsewhere in the Code), the court of appeals properly looked to judicial definitions of the phrase — including definitions of the phrase as used in Section 162 — to determine whether petitioners' investment activities rose to the level of a "trade or business." [4]

2. Contrary to petitioners' assertion (Pet. 8-9), the decision below does not conflict with, but rather is mandated by, this Court's decision in *Higgins* v. *Commissioner*, *supra*. The question there was whether expenses incurred by an investor in managing a large securities portfolio were deductible under the predecessor of Section 162(a) as incurred "in carrying on [a] trade or business." The taxpayer's investment decisions there were executed by a full-time staff "pursuant to his personal detailed instructions;" like petitioners here, he generally "sought permanent investments," although purchases and other transactions "caused limited shiftings in his portfolio" (312 U.S. at 214). The taxpayer argued that "the 'elements of continuity, constant repetition, regularity and extent' differentiate[d] his activities from the occasional like actions of the small investor" (*id.* at 215), so that he could be said to be "carrying on a

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[4]Petitioners suggest (Pet. 6) that Congress meant to give the words "trade or business" a special meaning in Section 280A, and hence that judicial definitions of the phrase as used elsewhere in the Code "are not helpful in determining [its] meaning" here. This suggestion ignores the way Section 280A operates. That Section does not itself allow any deductions. Rather, it *disallows* the deduction of certain expenses, deductible under other sections of the Code, if they are attributable to use of a residence. As noted above (page 5, *supra*), Congress intended that home-office expenses would pass muster under Section 280A only if they qualified for deduction under Section 162(a) rather than under Section 212(1). Thus, whether expenses are incurred "in carrying on any trade or business" within the meaning of Section 162(a) is not only a relevant, but the dispositive, criterion.

trade or business" whereas a small investor could not. This Court squarely rejected that argument, holding (*id.* at 218) that a taxpayer who manages his investments is not "carrying on a trade or business" regardless of the extent of his wealth or the amount of work entailed:

> The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board [of Tax Appeals].

The only distinction (if any) between this case and *Higgins* concerns the number of transactions executed, and the amount of time personally spent, by the respective taxpayers in managing their securities. But these are the very factors that *Higgins* held irrelevant in determining whether portfolio management is a "trade or business." The court of appeals thus correctly relied on *Higgins* (Pet. App. A8-A9) in support of its result.

Petitioners err in contending that the court below made "an incorrect application" of *Higgins* (Pet. 5) by "ignor[ing] the *Higgins* 'facts and circumstances' test" (*id.* at 11). This Court did state in *Higgins* (312 U.S. at 217) that "[t]o determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case." Both the Claims Court (Pet. App. A20-A21) and the court of appeals (*id.* at A6-A7), however, did examine the facts of this case, and found as a fact that petitioners were not traders, but were mere investors who managed their stocks and bonds for long-term growth. Following the legal analysis enunciated in *Higgins*, the court of appeals properly cited this factual finding in concluding that petitioners were not in a "trade or business" for tax purposes.

3. Petitioners' contention (Pet. 10-15) that the decision below conflicts with decisions of other courts of appeals is similarly without merit. As petitioners note (Pet. 8), this Court in *Higgins*, while holding that portfolio management is not a trade or business, declined to adopt the Commissioner's position that personal investment activity can *never* constitute a trade or business (312 U.S. at 215), thus implying that some type of activity might qualify. Subsequently, a number of courts have held that a taxpayer whose activity is that of a securities trader, rather than that of a mere investor, is engaged in a "trade or business." *E.g., Levin* v. *United States*, 597 F.2d 760, 765 (Ct. Cl. 1979); *Purvis* v. *Commissioner*, 530 F.2d 1332, 1334 (9th Cir, 1976); *Commissioner* v. *Nubar*, 185 F.2d 584, 588 (4th Cir. 1950); *Fuld* v. *Commissioner*, 139 F.2d 465, 468-469 (2d Cir. 1943); *Liang* v. *Commissioner*, 23 T.C. 1040, 1043 (1955). These cases generally distinguish between taxpayers who buy and sell securities for short-term profit and those who buy and hold securities for long-term growth, ascertaining the existence of a "trade or business" by reference to the taxpayer's investment intent and the nature of the profits he derives. See, *e.g., Levin*, 597 F.2d at 765; *Purvis*, 530 F.2d at 1334; *Liang*, 23 T.C. at 1043. The decision below, which employed the same analysis (Pet. App. A6), is thoroughly consistent with these decisions.

Petitioners err in seeking to posit a conflict (Pet. 5, 13-14) between the decision below and cases assertedly holding that a taxpayer, even though an investor rather than a trader, can be in a "trade or business" if he is "active" rather than "passive," that is, if he engages in "extensive, varied, continuous and regular" investment management. The only case cited by petitioners in which an "active" investor, who was not a trader, was held to be in a trade or business is

the Sixth Circuit's decision in *Kales* v. *Commissioner*, 101 F.2d 35 (1939).[5] That case, however, was disapproved by this Court in *Higgins*, for the Court granted certiorari there (312 U.S. at 215 n.5) to resolve a conflict between *Kales* and *Higgins* v. *Commissioner*, 111 F.2d 795 (2d Cir. 1940), which it affirmed. The Sixth Circuit itself has recognized that its "decision in the *Kales* case was impliedly, if not expressly, disapproved in *Higgins*." *Goodyear Investment Corp.* v. *Campbell*, 139 F.2d 188, 191 (1943). Since the Sixth Circuit no longer follows *Kales*, there is obviously no conflict of decisions warranting review by this Court.

4. Petitioners seek to paint a picture of general confusion in the lower courts, contending (Pet. 12) that the circuits during the past 45 years "have developed at least four inconsistent tests * * * to determine what constitutes a trade or business." This attempt is unavailing. To the extent that these "tests" are discrete at all, they are not inconsistent, but overlapping. They are, to some degree, merely different ways of saying the same thing, or are applications of a general principle to a particular situation. As applied to the present case — the case of a securities investor — all four of the tests petitioners describe must be satisfied before a "trade or business" may properly be found.

As petitioners note (Pet. 12-13), numerous courts of appeals, in making the "trade or business" determination for tax purposes generally, have adopted the so-called

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[5]The other cases petitioners cite for this proposition (Pet. 13) are inapposite. The Ninth Circuit's decision in *Maloney* v. *Spencer*, 172 F.2d 638, 640 (1949), involved not an investor in securities but a landlord-entrepreneur. The Fifth Circuit in *Commissioner* v. *Burnett*, 118 F.2d 659, 660 (1941), held that a taxpayer's "investment and speculative activities" did not amount to a trade or business under *Higgins*. The Court of Claims' decision in *Levin* v. *United States*, *supra*, and the Fourth Circuit's decision in *Commissioner* v. *Nubar*, *supra*, both involved "traders" rather than "investors."

"goods or services" test. The courts have held, in a wide variety of contexts, that a taxpayer is in a "trade or business" only if he holds himself out to others as selling goods and services. See, *e.g.*, *Gajewski* v. *Commissioner*, 723 F.2d 1062, 1065-1067 (2d Cir. 1983), petition for cert. pending, No. 83-1715 (full-time gambler); *Steffens* v. *Commissioner*, 707 F.2d 478, 481-482 (11th Cir. 1983) (corporate consultant and director); *Stanton* v. *Commissioner*, 399 F.2d 326, 329 (5th Cir. 1968) (inventor); *McDowell* v. *Ribicoff*, 292 F.2d 174, 177-178, (3d Cir.), cert. denied, 368 U.S. 919 (1961) (fiduciary administering decedent's estate); *Daily Journal Co.* v. *Commissioner*, 135 F.2d 687, 688 (9th Cir. 1943) (newspaper manager). The "goods or services" test, however, is just one requirement, not a comprehensive definition, of a "trade or business." See *Gajewski*, 723 F.2d at 1065.

The "trader versus investor" test, employed by the court below, is the rubric most commonly used in ascertaining the existence of a "trade or business" where a securities investor is concerned. This test grew out of the Court's analysis in *Higgins*, and its particular formulation probably owes to the fact that *Higgins* involved an investor in securities. It is consistent with the "goods or services" test because, as several courts have noted, a securities trader holds himself out as selling "goods," *i.e.*, stocks and bonds. See, *e.g.*, *Gajewski*, 723 F.2d at 1067 n.8; *Fuld*, 139 F.2d at 468-469. Indeed, the "trader versus investor" test may be viewed as but an application of the "goods or services" principle in a specific professional context.[6]

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[6]Petitioners suggest (Pet. 10-12) that the circuits are in conflict as to whether an investor in securities can *ever* satisfy the "goods or services" test. Compare *Gajewski*, 723 F.2d at 1067 n.8 (suggesting that a "professional investor * * * does offer goods to others in the sense that he buys and sells securities") (dictum), with *Helvering* v. *Wilmington Trust Co.*, 124 F.2d 156 (3d Cir. 1941), rev'd on other grounds, 316 U.S. 164

Petitioners correctly note, in describing their third "test" (Pet. 13-14), that a taxpayer's activities must be extensive, continuous and regular in order to constitute a "trade or business." Petitioners err, however, in proposing this as a self-sufficient touchstone for "trade or business," and in suggesting that other courts have treated it as such. To the contrary, this Court in *Higgins* rejected the argument that the extensiveness, continuity and regularity of an investor's activities are enough, in and of themselves, to render those activities a "trade or business" (312 U.S. at 218). And the only court of appeals that has adopted petitioners' stance — the Sixth Circuit in *Kales* — later abandoned it in light of *Higgins* (see pages 8-9, *supra*). Regularity and continuity of activity, rather than providing a comprehensive definition of "trade or business," represent but one relevant factor; they are a necessary, but insufficient, condition. It is of course true, as the court below acknowledged (Pet. App. A6), that the frequency of a taxpayer's securities trades may be relevant in determining whether he is a trader, and thus in determining whether he is in the "trade or business" of making investments. But the court below correctly refused to give the element of frequency any talismanic quality (*id.* at A2 n.1, A6), holding that a "trade or business" depends on the nature of and motivation for an activity, as well as on its continuity and regularity.

(1942) (suggesting that securities transactions do not involve the offer of "goods or services"). Even if these decisions were in conflict as to their reasoning, however, their approaches would produce identical results here. The Second Circuit in *Gajewski* indicated that an investor can qualify as a "professional investor," and thus be regarded as offering "goods or services," only if he is a trader. See 723 F.2d at 1067 n.8 (citing *Fuld* v. *Commissioner*, *Levin* v. *United States*, and *Purvis* v. *Commissioner*, all *supra*). Since the courts below found that petitioners were not traders, they could not prevail under either approach to the "goods or services" test.

Petitioners' remaining "test," the so-called "*Higgins* facts and circumstances' test" (Pet. 9), is not really a test at all, for it embodies no substantive legal standard. The court below (like other courts that have addressed the question) recognized that the "trade or business" inquiry under *Higgins* is a factual one (see 312 U.S. at 217). The court then proceeded to examine the facts of this case to determine, under the relevant legal criteria, whether petitioners' activities passed muster. There is no merit whatever to petitioners' assertion (Pet. 9) that the court below, or any other court, has "rejected" the *Higgins* analysis or has "found [it] unsatisfactory."

5. Finally, petitioners argue (Pet. 16) that the "trader versus investor" distinction is "irrational" as a matter of tax policy, contending that any taxpayer whose activities are "sufficiently extensive, varied, continuous and regular" is in a trade or business. Petitioners apparently believe that any income-producing activity should be deemed a "trade or business" if enough time and money are spent on it. But petitioners' emphasis on such quantitative factors as the size of their portfolios and the amount of money involved in their transactions merely distinguishes large investors from small investors. No reason is apparent why large investors should be treated as engaged in a trade or business, and thereby allowed to take home-office deductions unavailable to small investors.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1984

DOJ-1984-05